Petition

81-1673

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No. 81-

IN THE

Supreme Court of the United States

October Term, 1981

PHILADELPHIA NATIONAL BANK
and
PHILADELPHIA NATIONAL CORPORATION,
Petitioners

v.

UNITED STATES OF AMERICA,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED

1. Whether Temple University-Of The Commonwealth System of Higher Education, a statutorily structured instrumentality of Pennsylvania providing higher education, is a "political subdivision" within the meaning of 26 U. S. C. § 103(a)(1) so that loan interest it pays is exempt from federal income tax.

2. When Temple University-Of The Commonwealth System of Higher Education borrowed money because of delayed or insufficient legislative appropriations and passed the interest expenses on to the Commonwealth of Pennsylvania, was it acting "on behalf of" the Commonwealth within the meaning of 26 C. F. R. § 1.103-1(b) so that loan interest it paid was exempt from federal income tax.

NOTE: Philadelphia National Corporation is the parent corporation of Philadelphia National Bank. Philadelphia National Corporation has the following subsidiaries which are not wholly owned: Congress Factors Corporation; Philadelphia Overseas Finance Company; and Government Finance Associates, Inc.

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PHILADELPHIA NATIONAL BANK

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v.

UNITED STATES OF AMERICA,

Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners, Philadelphia National Bank and its parent, Philadelphia National Corporation (hereinafter collectively referred to as the "Bank"), respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit in this matter.

DECISIONS BELOW

The opinion of the Court of Appeals, reported at 666 F.2d 834, appears in the Appendix hereto at A2. The opinion of the District Court for the Eastern District of Pennsylvania, not reported, appears in the Appendix hereto at A18.

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on December 11, 1981. This petition was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S. C. § 1254(1).

STATUTE AND REGULATION INVOLVED

United States Code, Title 26:

§ 103. Interest on certain governmental obligations.

(a) General Rule.—Gross income does not include interest on—

(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia. . . .

Code of Federal Regulations, Title 26: § 1.103-1(b).

Obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit. . . . The term "political subdivision", for purposes of this section denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any State or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit.

STATEMENT OF THE CASE

A. The Tax Refund Claims

Philadelphia National Bank is a national banking association with its principal place of business in Ardmore, Pennsylvania. (A19, ¶ 1). During the years in question (1967-71), the Bank received $954,111 in interest on short and long term loans it had made to Temple University-Of The Commonwealth System of Higher Education ("Temple University" or "University"). (A21, ¶ 16). The Bank included the interest in its income during the years in question, paying a total of $474,402 in federal income tax directly attributable to those interest payments. (A21, ¶ 17). The Bank timely filed with the District Director of the Internal Revenue Service claims for refund of the $474,402 it paid in taxes plus statutory interest and certain deficiency interest. (A21-A22, ¶ 18). The basis of the claims was that interest paid by the University to the Bank was free from federal income tax under section 103 of the Internal Revenue Code of 1954 because (1) the University is a political subdivision within the meaning of 26 U. S. C. § 103(a)(1), and (2) the University borrowed "on behalf of" the Commonwealth of Pennsylvania within the meaning of 26 C. F. R. § 1.103-1(b). (A22, ¶ 19). The District Director of Internal Revenue denied the claims for refund. (A22, ¶ 20). Petitioners timely filed suit. (A22, ¶ 21).

B. Proceedings in the District Court

Petitioners brought this action in the United States District Court for the Eastern District of Pennsylvania invoking jurisdiction under 28 U. S. C. § 1346(a)(1), 28 U. S. C. § 1331(a) and 28 U. S. C. § 1340. After trial, the District Court granted Petitioners' refund claims, ruling that (1) the University is a "political subdivision" within

the meaning of 26 U. S. C. § 103(a)(1), and (2) the University borrowed from the Bank "on behalf of" the Commonwealth within the meaning of 26 C. F. R. § 1.103-1(b).

C. Proceedings in the Court of Appeals

Upon appeal by the government, the United States Court of Appeals for the Third Circuit reversed the ruling of the District Court, finding that (1) although it is an instrumentality of and is dependent upon the Commonwealth, the University is not a "political subdivision," and (2) there is an insufficient identity of interest, control and intent between the University and the Commonwealth to support a finding that the University issued its obligations on behalf of the Commonwealth.

D. Temple University-of the Commonwealth System of Higher Education

Petitioners ask this Court, in the context of the facts at bar, to define "political subdivision" and "on behalf of"—legal standards for qualifying as a tax-exempt issuer under 26 U. S. C. § 103(a)(1). It is submitted that the statutory structure and powers of Temple University and its close relationship to the Commonwealth of Pennsylvania qualify the University as a tax-exempt issuer under the proper legal standards, thus entitling Petitioners to the relief requested.

The University was organized in 1884 as a private educational institution under the name of The Temple College of Philadelphia. (A19, ¶ 4). In 1965, however, Pennsylvania comprehensively reorganized the University by enacting the Temple University—Commonwealth Act, P. L. 843, 24 Pa. Stat. Ann. §§ 2510-1 *et seq.* (1981-82 Pocket Part) ("Commonwealth Act"), which changed the University's name, structure and purpose. (A22, ¶¶ 23-24). The Commonwealth Act transformed the Uni-

versity into "an instrumentality" of the Commonwealth of Pennsylvania and, like Pennsylvania State University, charged it with the responsibility to fulfill Pennsylvania's constitutional duty (Article III, Section 14 of the Pennsylvania Constitution) (A29, ¶ 62) of providing public higher education to the citizens of the Commonwealth. (A23, ¶¶ 26-28; A3).

As an essential component of the 1965 statutory reorganization, the Commonwealth committed itself to underwrite the University's operations through both substantial annual appropriations and the major development of its campus. (A24, ¶ 32). During the years 1966-67 through 1971-72, the Commonwealth appropriated to the University approximately $200,000,000 for operations and approximately $55,000,000 for capital improvements. Exclusive of the University's hospital operations, Pennsylvania's appropriations constituted at least 50% of the University's annual revenues during these years. (A24-A25, ¶ 34; A5). By June 30, 1971, the Commonwealth had paid for 40% of the University's total physical plant. (A27, ¶ 49; A5).

The Commonwealth Act furnished further support by exempting the University, as is Pennsylvania State University, from a variety of taxes, including sales, use and realty transfer taxes. (A28-A29, ¶¶ 57-59). Indeed, the Commonwealth authorized the University, like Pennsylvania State University, to issue bonds which are tax exempt, thus relieving the owners of the bonds from state income taxes on the interest received from the University. And, by statute, no transfer taxes may be imposed on the University's bonds. 24 Pa. Stat. Ann. § 2510-9. (A26, ¶ 40; A4).

Under 26 U. S. C. § 103(a)(1) and the regulations promulgated thereunder, a "political subdivision" must have "part of the sovereign powers" of the state. Those sovereign powers are the police power, the power of tax-

ation and the power of eminent domain. (A11). The Commonwealth has granted the University a substantial measure of sovereign powers to enable the University to fulfill its statutory obligation to provide higher education to the public. The University's sovereign powers are identical to those granted by the Commonwealth to Pennsylvania State University. (A30, ¶¶ 69-70).

The University has and exercises the Commonwealth's police power. (A36). It issues rules and regulations governing conduct within its boundaries (A31, ¶ 77) and maintains an armed and uniformed police force of approximately 150 full-time members (A28, ¶ 56) with the power to arrest and prefer charges. (A28, ¶ 54). The campus police are authorized to and do enforce the University's rules and regulations, the Commonwealth's laws and Philadelphia ordinances. Act of July 7, 1968, P. L. 297, No. 149, 71 Pa. Stat. Ann. § 646 (1963-1980 Supplementary Pamphlet). In fact, that statute explicitly authorizes the University's police "[t]o exercise the same powers as are now or may hereafter be exercised under authority of law or ordinance by the police of the cities of Harrisburg, Pittsburgh, and Philadelphia . . . ." 71 Pa. Stat. Ann. § 646(e). (A28, ¶ 53).[1] *Cf. American Future Systems,*

1. The Third Circuit Court of Appeals erred when it concluded, without explanation and contrary to the factual findings of the District Court, that the campus police are not authorized to enforce laws enacted by the University and charges may not be brought before school authorities. (A13). Ironically, in *Henderson v. Fisher*, 631 F. 2d 1115, 118 (3d Cir. 1980), the Third Circuit had previously acknowledged that 71 Pa. Stat. Ann. § 646 represented the Commonwealth's "delegation of police powers, a government function to the campus police." Concurring, Judge Adams reasoned that "71 Pa. Stat. Ann. § 646 . . . delegates to the campus police—for the purpose of enforcing state, local, or campus law and of maintaining order on campus—essentially all powers possessed by municipal police." *Id.* at 1121, n. 9.

Inc. v. Pennsylvania State University, 618 F. 2d 252, 255 (3d Cir. 1980); *Brush v. Pennsylvania State University*, 489 Pa. 243, 250, 414 A. 2d 48, 52-54 (1980).

The University enjoys the power of eminent domain. (A37). During the years in dispute, the Pennsylvania General State Authority ("GSA") exercised eminent domain power for the Commonwealth and its agencies and instrumentalities. By statute, the GSA was authorized to condemn land for the University. 24 Pa. Stat. Ann. § 2510-7. The GSA did so routinely. In fact, during the years covered by this suit, the GSA exercised the power of eminent domain ninety-seven times—every time the University called for it. (A26-A28, ¶¶ 42-52).

The University does not itself possess the power to levy taxes, but it benefits directly and substantially from the Commonwealth's taxing power. As the District Court found, "the state annually uses its power to tax and appropriate funds on Temple's behalf". (A37).

In return for the grant of these financial subsidies and sovereign powers, the Commonwealth scrutinizes and controls University operations in a variety of ways. First, by statute the Commonwealth specifies the uses to which its appropriations must be put. For example, for the 1969-70 fiscal years, Act 6A, March 13, 1970, the Commonwealth allocated $38,972,000 for resident education, $52,000 for extension services, $542,000 for organized research, $171,000 for special departmental research, and $1,655,000 for the University computer center. In the early years following passage of the Commonwealth Act, the appropriation acts actually specified the minimum tuition rates to be charged. (A25, ¶ 35). More generally, the sheer magnitude of the Commonwealth support to the University, and the severe handships suffered when that support was not adequately and timely provided, gave the Commonwealth power to direct and control the University's

operations. *Samuel v. University of Pittsburgh*, 375 F. Supp. 1119, 1126 (W. D. Pa. 1974). *Cf. Rackin v. University of Pennsylvania*, 386 F. Supp. 992, 1004-05 (E. D. Pa. 1974). The University is dependent upon state support. (A31, ¶ 78).

Second, under the Commonwealth Act, the University must, and does, report annually to the Auditor General of the Commonwealth concerning its use of Commonwealth appropriations. 24 Pa. Stat. Ann. § 2510-8. Furthermore, the Auditor General annually audits University fiscal affairs by sending in a team of examiners who spend weeks going through the University's books and records. To give teeth to the annual audit, the Auditor General has the statutory power to disallow improper expenditures of state funds and to cause such sums to be paid back by the University to the Treasurer of the Commonwealth. (A25, ¶¶ 36-38).

Third, the University, through its president, is statutorily required to, and does, annually submit to the Governor of the Commonwealth and to the state legislature an extensive report on the University's activities during the preceding academic year. 24 Pa. Stat. Ann. § 2510-10. (A26, ¶ 39; A4). The legislature has even required the University to compile and submit comprehensive annual reports on the productivity of its faculty. *See Isaacs v. Board of Trustees of Temple University*, 385 F. Supp. 473, 481 (E. D. Pa. 1974).

Fourth, the Commonwealth has imposed direct restrictions on the University's activities. For example, Pennsylvania not only legislatively established the University's minimum tuition rates for residents and non-residents, but also required the University to follow written residency rules promulgated by the Auditor General of the Commonwealth when classifying students for purposes of the reduced tuition available to Pennsylvania residents.

(A24, ¶¶ 32-33). *See Samuel v. University of Pittsburgh, supra,* 375 F. Supp. at 1119.

Fifth, the State Board of Education must approve the establishment of new branches, campuses and professional schools before the University can undertake such expansion. 71 Pa. Stat. Ann. § 367 (1963-1980 Supplementary Pamphlet).

Sixth, the Commonwealth maintains a significant presence on the University's board of trustees. One-third of the trustees on the University's board are designated by elected state officials and, in addition, the Governor of the Commonwealth, the Secretary of Education of the Commonwealth and the Mayor of the City of Philadelphia are trustees *ex officio*. 24 Pa. Stat. Ann. § 2510-4. (A23-A24, ¶ 29; A4).

In sum, the Commonwealth regulates and exercises substantial control over the University. *Isaacs v. Board of Trustees of Temple University, supra,* 385 F. Supp. at 481. The Report of the Higher Education Committee, The House of Representatives, Commonwealth of Pennsylvania (1965-1966), described the significance of the state's power as follows:

> Through the Commonwealth Trustee representation and the post-audit controls incorporated into the legislation, the Commonwealth is assured of its rightful share in the control of the institution, and the General Assembly is assured at all times of the right to require such information on the operations of the institution as will enable it to perform its proper legislative functions.

Since 1965, the University and the Commonwealth have operated within the strict statutory structure described above. Unfortunately, in 1969-70 and again in 1970-71 the Commonwealth was painfully late in appro-

priating and paying funds to the University. Additionally, in several years the amounts appropriated fell short of the University's budgeted requirements. (A21, ¶ 15; A26, ¶ 41; A5). To enable it to continue to educate when the Commonwealth was not making payments, the University was forced to borrow massive amounts of money from banks on a short-term basis. To illustrate, in 1969-70, when appropriation payments from the Commonwealth were delayed many months, the University had to borrow more than $32 million. In 1970-71, the short-term loans needed by the University to continue operating in the absence of state payments climbed to roughly $44 million. The interest costs of borrowing these funds was subsequently passed on by the University to the Commonwealth through the appropriations process. (A31, ¶ 79). In sum, the need to borrow was created by the Commonwealth and the burden of the debt ultimately fell upon the Commonwealth.

REASONS FOR GRANTING THE WRIT

1. This Court Should Grant Certiorari to Establish That a Statutorily Structured Instrumentality of a State Responsible for Carrying Out a Fundamental Governmental Function and Possessing Substantial Sovereign Power Is a "Political Subdivision" Within the Meaning of Section 103

Section 103(a)(1) of the Internal Revenue Code does not define "political subdivision." The regulations promulgated under that section cryptically state that a "political subdivision" is "any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit." 26 C. F. R. § 1.103-1(b). Whether an entity qualifies as a "political subdivision" determines its ability to borrow money at lower, tax-exempt rates. Despite the obvious importance of the definition of "political subdivision," this area of the law is noted for its sparse and inconclusive case law and a pattern of inconsistent rulings from the Internal Revenue Service.

The Court of Appeals for the Third Circuit, noting the lack of guidance on the scope of "political subdivision," stated (A7):

> [T]here is surprisingly little decisional law on what constitutes a political subdivision within the meaning of § 103. The Supreme Court has never addressed the issue, and the leading—and almost only—cases on point were decided by the Court of Appeals for the Second Circuit. *Commissioner of Internal Revenue v. Shamberg's Estate*, 144 F. 2d 998 (2d Cir. 1944), *cert. denied*, 323 U. S. 792 (1945), and *Com-*

missioner of Internal Revenue v. White's Estate, 144 F. 2d 1019 (2d Cir. 1944), *cert. denied*, 323 U. S. 792 (1945).

Petitioners submit, and the District Court agreed, that the University is a "political subdivision" under the *Shamberg* and *White* opinions. The Court of Appeals for the Third Circuit, however, disagreed, applying a shortsighted and narrower test. Petitioners believe that what the Third Circuit failed to appreciate, but what was fully recognized by the District Court and the Second Circuit, is that the concept of "political subdivision" is necessarily an evolving one. In *Shamberg*, *supra* at 1000, the government had argued that the New York Port Authority, established in 1921, could not qualify as a tax-exempt issuer because such an entity was not within the contemplation of Congress when the predecessor to Section 103(a)(1) was adopted in 1913. Rejecting this interpretation, the Second Circuit found that Congress' purpose in exempting "the bonds of states and their agencies when engaged in customary governmental activity" was a "broad" one and held that an entity created by the states, exercising a public purpose, and with some public powers qualified as a "political subdivision." Petitioners agree with the Second Circuit and submit that Temple University qualifies as a "political subdivision" under that test.

The more narrow view of the Third Circuit is particularly unfortunate in this era of high interest rates and new federalism, both imposing increasing financial burdens on the states. Under these circumstances, one must expect states to tailor their instrumentalities to fit evolving needs and conditions. While serving important governmental functions, these entities will not all look like the strict traditional concept of a "political subdivision." The District Court recognized this when it concluded (A38-A39):

> As states devise increasingly ingenious mechanisms for carrying out public purposes, and indeed for combining public and private purposes, it becomes more difficult to determine what obligations are issued "on behalf of" the state [or] by a "political subdivision" of the state . . . . Temple is a political subdivision in a modern form.

The Third Circuit's hidebound opinion improperly hampers the ability of modern state instrumentalities to obtain tax-free financing and should be reversed.

Equally distressing is the Internal Revenue Service's inconsistent rulings in the area. The government has issued obviously contradictory interpretations of "political subdivision" and, as a result, has failed to be evenhanded in its administration of the tax laws.

In Revenue Ruling 73-563, 1973-2 Cum. Bull. 24 (A44), the Internal Revenue Service determined that interest paid by a rapid transit authority was tax free because the authority was a "political subdivision". Like Temple University, the authority was created by state statute to perform a public function. Like the University, the authority was authorized to maintain a security force to protect its property and facilities and issue rules concerning conduct within its boundaries. Like the University, the authority did not itself have power to tax or the power of eminent domain, but the local governmental units in which the authority operated exercised eminent domain power on its behalf. On these facts, the authority was held to possess a sufficient measure of sovereign powers to render its interest free from tax. The facts pertinent to Temple University require the same result.

Revenue Ruling 77-165, 1977-1 Cum. Bull. 21, however, stands in opposition to Revenue Ruling 73-563. In Revenue Ruling 77-165, the Internal Revenue Service

found that a state university was not a "political subdivision" within the meaning of 26 U. S. C. § 103(a)(1) even though the university had police power that was similar to that possessed by the transit authority, the university had a more substantial measure of eminent domain power than the transit authority and both the university and the transit authority benefitted from the state's power to tax.

Equally inexplicable is the Internal Revenue Service's inconsistent treatment of Temple University and Pennsylvania State University. Pennsylvania State University has, in all material aspects, the same relationship to Pennsylvania as Temple University has to Pennsylvania. Nevertheless the Internal Revenue Service issued letter rulings to Pennsylvania State University in 1955 and 1957 (A47-A51) which acknowledged that Pennsylvania State University is a section 103 borrower. The Internal Revenue Service has denied that status to Temple University. The government's conclusion that Pennsylvania State University "is an instrumentality of the Commonwealth of Pennsylvania performing the essential governmental function of education, and is supported by appropriations of funds by the legislature" (A47), is equally true for Temple University.

This Court should grant certiorari for the purpose of determining what constitutes a "political subdivision" entitled to issue tax-exempt obligations. Such a decision is needed (1) to ease the financial burdens of states and their instrumentalities by permitting them to obtain tax-free financing, (2) to clarify the law so that it is administered evenhandedly, and (3) to enable bondholders to know how to treat interest payments properly for tax purposes.

It is submitted that Temple University meets the proper standard. As the District Court held, the University is a statutorily structured instrumentality of the Commonwealth of Pennsylvania which is responsible for carrying out Pennsylvania's constitutionally mandated

duty to provide public higher education to the citizens of the Commonwealth and which has been given substantial sovereign powers. It is entitled to borrow interest on a tax-free basis.

2. This Court Should Grant Certiorari to Establish That a Governmental Instrumentality Performing a Public Function Which Borrows Funds in Furtherance of That Function Is an "On Behalf Of" Issuer Within the Meaning of Section 103

Interest paid on debt issued "on behalf of" any State or local governmental unit by constituted authorities empowered to issue such obligations, even if not a "political subdivision," also is exempt from Federal income tax. There is virtually no judicial or regulatory analysis of what constitutes an "on behalf of" issuer.

The District Court held that Temple University, as an instrumentality of the Commonwealth of Pennsylvania performing a public function and borrowing funds in furtherance of that function, borrowed "on behalf of" the Commonwealth when appropriations were deferred or deficient. The Court of Appeals, using an unprecedented control requirement, reversed.

Temple University's borrowings were compelled because the Commonwealth was late in paying appropriations to the University or because the Commonwealth appropriated insufficient funds. The loans enabled the University to satisfy its statutory obligations to the Commonwealth and interest paid by the University on those loans was later passed on to the Commonwealth of Pennsylvania in the appropriations process.

It was in precisely this setting of borrowing to offset late or inadequate appropriations that the Internal Revenue Service concluded that loans of Pennsylvania State University, the University's sister institution, were exempt under Section 103(a)(1). The letter ruling issued to

Pennsylvania State University on November 10, 1955 provided in pertinent parts as follows (A47-A48):

> The Pennsylvania State University is the land grant university of Pennsylvania. It is an instrumentality of the Commonwealth of Pennsylvania performing the essential governmental function of education, and is supported by appropriations of funds by the legislature.
>
> The fiscal year of the Commonwealth of Pennsylvania ends on May 1, 1955, and the University on June 30, 1955. Inasmuch as no appropriations have been passed by the legislature or approved by the Governor for the next fiscal year, it will be necessary for you to borrow money. The money so borrowed will be repaid, together with interest thereon, with the funds that are eventually appropriated by the legislature.
>
> * * *
>
> Based on the above-stated information, it is the opinion of this office that any notes or other obligations issued by the University for the above-stated purpose are to be regarded as instrumentalities of the State of Pennsylvania. Accordingly, the interest on such obligations will be excludable from the gross income of the recipient for Federal income tax purposes pursuant to the terms of section 103(a)(1) of the Internal Revenue Code of 1954.

Temple University is entitled to the same treatment.

There was simply no basis for the Court of Appeals to deny "on behalf of" status to the University by creating a "control" test. In any event, the Commonwealth does exercise significant control over the University. This Court should grant certiorari to define the scope of the "on behalf of" provisions.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit.

Respectfully submitted,

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Appendix

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1331

PHILADELPHIA NATIONAL BANK and
PHILADELPHIA NATIONAL CORPORATION,
Appellees

v.

UNITED STATES OF AMERICA,
Appellant

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

(D.C. CIV. No. 79-0941)

Argued October 14, 1981

Before: HUNTER, ROSENN and WEIS, *Circuit Judge.*

(Opinion filed December 11, 1981)

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OPINION OF THE COURT

WEIS, *Circuit Judge.*

Interest on money borrowed by political subdivisions is exempt from federal income tax. In this case, the district court concluded that Temple University, a state-related school in Pennsylvania, had sufficient governmental functions and powers to qualify as a political subdivision. Our review of the record, however, persuades us that although the university has close ties with and is dependent upon the state, a delegation of essential governmental power did not take place. Accordingly, we reverse a judgment in favor of the plaintiff bank which had received interest from Temple.

Philadelphia National Bank sued the United States for a refund of taxes paid on interest received from loans to Temple University, contending that under § 103(a)(1) of the Internal Revenue Code, 26 U.S.C. § 103(a)(1)

(1976), the university was a "political subdivision." After a bench trial, the district court entered judgment in favor of the bank in the amount of $474,402.

The facts in the case are largely undisputed. Temple University, a private non-profit corporation in Philadelphia, was founded in 1888 as an educational institution. Under the direction of its Board of Trustees, the school expanded its activities over the years to become a major metropolitan university, but growing financial difficulties required it to consider a change in its structure. Temple's fiscal need coincided with the Commonwealth's desire to meet its constitutional obligation to provide public education by extending opportunities for university training. Recognizing that a formal relationship with the state would be mutually beneficial, the school agreed to reorganization in 1965 pursuant to the Temple University-Commonwealth Act. 24 PA. CON. STAT. ANN. § 2510-1 *et seq.* (The Commonwealth Act).

One of the major reasons for the legislation was the state's desire to reduce tuition rates by providing financial assistance through annual appropriations. In addition, by statutorily "incorporating" the university into its educational system, the state avoided the much greater cost of establishing and constructing a new public university. Report of Higher Education Committee, House of Representatives, Commonwealth of Pennsylvania, 1965-66, at 39-40.

The stated purpose of the Act is "to extend Commonwealth opportunities for higher education by establishing Temple University as an instrumentality of the Commonwealth to serve as a State-related institution in the Commonwealth system of higher education." *Id.* at § 2510-2. The institution was renamed "Temple University — Of The Commonwealth System of Higher Education" to reflect its new status. *Id.* at § 2510-3. This section provides

that, as renamed, Temple "shall continue as a corporation for the same purposes as, with all rights and privileges heretofore granted to, Temple University, unless hereinafter modified or changed."

As a consequence of the legislation, Temple reconstituted its Board of Trustees to consist of 36 regular members and three ex-officio members, the Governor of Pennsylvania, the Secretary of Education, and the Mayor of Philadelphia. *Id.* at § 2510-4(a). Twelve of the 36 members are designated as Commonwealth Trustees and are appointed by the Governor, President pro tempore of the Pennsylvania Senate, and Speaker of the Pennsylvania House of Representatives. *Id.* at § 2510-4(b).

The state imposes some controls on the university. For example, it is subject to audit of expenditures by the State Auditor General. Moreover, the President of the school must make an annual report to the legislature.

The General Assembly is empowered to set tuition schedules whenever it makes adequate appropriations to the university, but otherwise the management and control of the instructional, administrative, and financial affairs of the university are entrusted to the Board of Trustees.

Temple receives capital improvement benefits comparable to those given land grant colleges and state colleges. For example, the Commonwealth, by agreement with Temple, may "acquire lands, erect and equip buildings, and provide facilities for the use of the university." *Id.* at § 2510-7.

Although it is precluded from pledging the credit of the Commonwealth, "the board of trustees may provide for the issuance of bonds in the name of the university for any proper purpose in the same manner as heretofore." *Id.* at § 2510-9(a). Such obligations, and the income therefrom, are not taxable by the Commonwealth. *Id.* at § 2510-9(c).

After the legislation was enacted, the state's annual appropriation to Temple rose from $20,106,998 in 1966 to $44,568,000 in 1971-72. These amounts represented 50.6% to 62.7% of the unrestricted revenue of the school. During the same period, the General State Authority of Pennsylvania built nine structures for Temple. Land for five of these was acquired in part by condemnation, and in four instances the Authority received the land by conveyance from the university. By 1971, the General State Authority owned 40% of Temple's physical plant. The State does not charge Temple for the use of these facilities nor is there a lease with the school. Property acquired by Temple before 1966 remains in the university's name.

Because the annual Commonwealth appropriations were either inadequate or delayed, during the years 1967 through 1971 Temple had to borrow extensively from the plaintiff bank. The proceeds were used to pay operating expenses and to redeem debenture bonds. The interest rate on each loan was set at the regular commercial rate, and was not discounted because of an expected interest exemption from federal income taxes.

After considering the relationship between Temple and the State created by the legislation, the district court concluded that Temple is "a political subdivision in a modern form" and that, as an instrumentality of the state, the university borrows " 'on behalf of' the Commonwealth of Pennsylvania." The court commented that Temple "*exercises* (even if it might not be said to 'possess') every significant sovereign power necessary to effectuate [Pennsylvania's policies for higher education]." This is so, according to the district court, because Temple has a campus police force and charges tuition for performing a recognized public service, akin to tolls on state-owned turnpikes. In addition, Temple is a beneficiary of eminent

domain through its requests to the General State Authority to condemn certain property.[1]

On appeal, the United States argues that Temple is a private, non-profit corporation, governed by a privately controlled Board of Trustees, and has not been delegated sovereign power. The bank contends that Temple is an instrumentality of the state, carries on a public function, possesses police power, and enjoys benefits from the state eminent domain and taxation powers. In addition, the bank asserts that the university issues obligations "on behalf of" the state.

The bank can obtain a § 103 exemption if Temple is deemed to be a political subdivision or if Temple issued the obligations "on behalf of" the state. We will discuss these possibilities separately.

The starting point must be the statute itself. In pertinent part it reads:

> "(a). Gross income does not include interest on — (1) the obligations of a State . . . or any political subdivision of any of the foregoing . . . ."

26 U.S.C. § 103(a)(1).

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1. Pennsylvania State University, a land grant school with a closer relationship to the Commonwealth, received Internal Revenue Service private rulings in 1955 and 1957 stating that interest payments on its obligations were exempt. The district court recognized that Temple could not rely on those private letter rulings, *see* Weller v. Commissioner, 270 F.2d 294, 298-99 (3d Cir. 1959), but nonetheless expressed the belief that both schools should be treated alike because similar circumstances were involved.

Even if the private rulings to Penn State University were entitled to some weight, their continued validity is doubtful in light of a more recent published ruling. In Rev. Rul. 77-165, the Commissioner determined that a state university was not a political subdivision within the meaning of § 103. That ruling not only casts doubt on the success of future requests by Penn State, but reveals that the service does not think state universities, much less state-related institutions, should be given political subdivision status for purposes of § 103.

The statute is explained somewhat by a longstanding Treasury Regulation which defines political subdivisions as "any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit." 29 C.F.R. § 1.103-1(b).

There is surprisingly little decisional law on what constitutes a political subdivision within the meaning of § 103. The Supreme Court has never addressed the issue, and the leading — and almost only — cases on point were decided by the Court of Appeals for the Second Circuit. *Commissioner of Internal Revenue v. Shamberg's Estate,* 144 F.2d 998 (2d Cir. 1944), *cert. denied,* 323 U.S. 792 (1945), and *Commissioner of Internal Revenue v. White's Estate,* 144 F.2d 1019 (2d Cir. 1944), *cert. denied,* 323 U.S. 792 (1945).

In *Shamberg,* the court held that interest paid on bonds issued by the Port of New York Authority was exempt from federal income tax. The Authority, a body politic and corporate, had been created by a compact between New Jersey and New York, and was governed by a Board of Commissioners, whose members were appointed by the two states.

The Authority was formed to construct and operate toll bridges and tunnels in the New York area, was granted the power of eminent domain and was immunized from suit. It had a police force whose members were designated by statutes of both states as regular police and peace officers. The Authority also had the power to make and enforce regulations governing the operation and maintenance of bridges and tunnels within its control. 144 F.2d at 1002-03.

The court of appeals held that the Authority's activities were "exercised for a public purpose by an agency set up by the states and given many public powers, though

not of taxation or control through the suffrages of its citizens. It minimizes its public and political character to treat such an agency as a private corporation merely because of the lack of taxing power which is only one of the attributes of sovereignty." 144 F.2d at 1005. The court quoted approvingly from a 1914 opinion of Attorney General McReynolds that to be denied a political subdivision, a body need not exercise all of the public functions of the state, it being sufficient if the organization had authority to exercise a portion of them.

In *White's Estate*, bonds were issued by the Triborough Bridge Authority, which had been designated by the New York Legislature as a "body corporate and politic constituting a public benefit corporation." Like the Port Authority in *Shamberg*, it was authorized to issue bonds, but not as debts of the city or state. 144 F.2d at 1019-20. After the bonds were fully paid, the bridges which they had financed were to revert to the City of New York.

At the time the Triborough bonds were issued, the Commissioner of Internal Revenue had sent a letter ruling to the Authority stating that "the Authority is in effect an instrumentality of the City of New York, a political subdivision of the State," that the bonds "will be, in effect, bonds of the city issued in the exercise of its borrowing power" and hence exempt under § 103. *Id.* The court agreed with that assessment, and held that the Authority was "plainly a subdivision of state government empowered to exercise governmental functions on behalf of the City of New York. . ." and that "[t]he Authority is in essence a Department of the city . . . ." *Id.*

There are similarities between the entities discussed in these two cases and Temple University, but there are also significant differences. Unlike Authority Boards whose members are appointed by the government, the majority of the Board that controls Temple is composed of

private citizens elected by that very same body. Other divergencies make it apparent that the method utilized by the legislature to establish a state relationship with Temple is unique and the resulting body is not the same as a traditional authority or political subdivision.

The Supreme Court of Pennsylvania discussed Temple's status in *Mooney v. Board of Trustees of Temple University of the Commonwealth System of Higher Education*, 448 Pa. 424, 292 A.2d 395 (1972). In that case the issue was whether the school was a state "agency" and thus subject to the Inspection and Copying Records Act, a state version of the Freedom of Information Act.

The Pennsylvania court noted that "agency" was statutorily defined as "any political subdivision of the Commonwealth . . . or any State or municipal authority or similar organization. . . ." 292 A.2d at 397, *quoting* 65 P.S. § 66.1(1). Emphasizing the Temple legislation statement that the university should continue as a corporation for the same purposes and with all the rights and privileges "heretofore granted," the court said,

> We conclude, as did the Commonwealth Court, that this latter declaration reveals an express legislative intent to preserve Temple's status as a non-profit corporation chartered for educational purposes. The receipt by Temple of increased state financial aid no more transforms Temple into a state 'agency' than the receipt of federal funds can make Temple an agency of the federal government.

Id. at 399.

The court observed that the Commonwealth trustees only constituted a one-third minority of the Board, leaving the majority of non-public trustees with the power to manage and control the university. Temple also continued

to own the land, buildings and facilities which it possessed before the Act became effective. Important to the court also was that before the state could expand or alter Temple's facilities, it had to reach an agreement with the trustees. Requiring such approval was thought to be inconsistent with the contention that Temple was a state agency, 292 A.2d at 399, for, as the court reasoned, if Temple were truly a state "agency," the state would wholly control the decisions to be made regarding it.

The provision giving the Auditor General limited responsibility to audit the funds appropriated by the Commonwealth was described by the court as "another indication of the Legislature's intention to preserve Temple's prior status, and not to transform Temple into a state 'agency'." 292 A.2d at 400.

We recognize that, particularly in tax cases, holdings taken from other contexts may be inappropriate. Nevertheless, *Mooney* is an authoritative interpretation of the pertinent state statute and must be carefully considered.

On the other hand, such cases as *Henderson v. Fisher*, 631 F.2d 1115 (3d Cir. 1980); *Braden v. University of Pittsburgh*, 552 F.2d 948 (3d Cir. 1977); and *Isaacs v. Board of Trustees of Temple University-of the Commonwealth System of Higher Education*, 385 F.Supp. 473 (E.D. Pa. 1974), which explore whether activities of state-related universities are "state action" within the ambit of 42 U.S.C. § 1983, are of little assistance here. In those cases, the issue was whether a sufficient symbiotic relationship existed between the school and the Commonwealth so that there was liability for civil rights violations.

A finding of joint activity that may constitute state action does not, however, make a private party a state "agency" or political subdivision. This is clearly demon-

strated by *Burton v. Wilmington Parking Authority*, 365 U.S. 715 (1961), where the actions of a privately owned restaurant were found to be "state action" because of its close ties with a parking authority which was a state agency. *Id.* at 724-25. The finding of state action by the restaurant did not transform that private enterprise into a governmental body. Similarly, the holding in *Isaacs v. Temple* that there was state action does not establish that the University is a political subdivision, nor did the court purport to address that issue.

Equivalent considerations are applicable to litigation that Temple had before the National Labor Relations Board. That an entity may have some governmental characteristics for certain purposes does not necessarily control its status under a different statutory scheme. *See, e.g., Truman Medical Center, Inc. v. NLRB*, 641 F.2d 570, 572-73 (8th Cir. 1981). Thus the fact that the NLRB declined to exercise jurisdiction over a labor matter at Temple because of its unique relationship with the state is not determinative. *See Temple University-of the Commonwealth System of Higher Education*, 194 NLRB 1160 (1972).

Since we must resolve the question in the context of the Internal Revenue Code itself, we turn to the delegation of state sovereignty test mentioned in the Treasury Regulation and discussed in *Shamberg* and *White*. The three sovereign attributes discussed are the power to tax, the power of eminent domain, and the police power.

Neither in *White* nor *Shamberg* or in the case at hand was the power of taxation conferred by the state. The bank contends that since the university benefits from the State's power to tax through legislative appropriation of funds, there is to some extent a delegation of the tax power. We do not find that argument convincing. Every contractor who deals with the state receives similar benefits,

but those private individuals cannot levy taxes to collect the sums owed them by the state, and neither can Temple.[2]

In *Shamberg* and *White*, each Authority was granted the power of eminent domain. No such authorization was extended to Temple. When it wishes to erect additional facilities, the university must request the General State Authority to procure the property. The power to condemn selected property is vested in the Authority, and the fact that it has cooperated with the university by accepting and implementing its suggestions does not constitute a grant of sovereign power to Temple.

It is clear that the General State Authority could decline to acquire any given site. The fact that the state retains title to the land (and buildings) obtained by eminent domain further demonstrates that Temple does not possess the power of condemnation, even though incidentally benefiting by the state's exercise of its prerogative.

The third indicia of sovereignty, the police power, is not established here by the existence of a campus police force. As the Court said in *Chicago, Burlington & Quincy Railway Co. v. Illinois, ex rel. Drainage Commissioners*, 200 U.S. 561, 592 (1906), "the police power of a State embraces regulations designed to promote the public convenience or the general prosperity, as well as regulations designed to promote the public health, the public morals or the public safety." In the context of governmental

2. The Revenue Rulings are not particularly helpful with respect to evaluating the delegation of the power to tax as an aspect of sovereignty. For example, in Rev. Rul. 77-164, even though a community development authority was given the authority to impose and collect fees for capital improvements, this was not found to be taxing power. In contrast, Rev. Rul. 73-563, a state rapid transit authority received benefits because local governmental bodies exercise the tax power on its behalf. In that instance, the indirect method of taxation was nevertheless said to be sufficient to constitute a delegation of the power to tax.

authority, therefore, the "police power" is much more than the power to maintain a corps of police officers. The Supreme Court succinctly defined this attribute of sovereignty by saying that "In a sense, the police power is but another name for the power of government . . . ." *Mutual Loan Co. v. Martell*, 222 U. S. 225, 233 (1911).

The maintenance of a campus police force, even with the limited power of arrest granted by a separate state statute, 71 PA. CONS. STAT. ANN. § 646 (Purdon Supp. 1971), not only applies to state-related institutions like Temple but to "state-aided" schools as well. To say the least, it is highly unlikely that Pennsylvania intended to confer its police power on colleges less closely related to it than Temple. Moreover, the campus police are authorized to enforce laws enacted by the state, not by the university, and charges must be brought before state judicial officers, not school authorities. Nor can it be said that because Temple creates and enforces rules of conduct and instructional policies, its authority is analogous to the "power of government." Those who enter upon Temple's premises as students, faculty or otherwise, do so voluntarily and accept the necessary regulation that accompanies such an undertaking.

In the *Shamberg* case, by contrast, the Authority was given the power to enact rules and regulations effective as to the general public and enforceable through the criminal courts. In addition, New York enacted legislation giving the Authority the power of subpoena and the power to enforce its orders in the civil courts. 144 F.2d at 1002-03. In short, the Authority in *Shamberg* had been delegated substantial portions of the state police power to insure the proper operation and control of the bridges and tunnels within its jurisdiction.

At most, the university has been given a limited authorization to exercise one small aspect of police power —

one that has been delegated to private organizations as well. With such a minimal grant of police power, and with no eminent domain or taxing power, Temple cannot be said to be a political subdivision.

Accepting *arguendo* that Temple's work of providing higher education is the performance of a governmental, public function,[3] it must be noted that the Commonwealth meets but part of the demand, for the state-related institutions are far outnumbered by private colleges and universities. *See Old Colony Trust Co. v. United States*, 438 F.2d 684, 687 (1st Cir. 1971). Here again, Temple is quite different from the entities in *Shamberg* and *White*, which bore the responsibility for construction and maintenance of bridges and tunnels, functions which in modern society are practically always assumed by governmental bodies.

As an alternative ground, the Bank contends that because the proceeds of the loan to Temple were used to defray expenses which would otherwise have been met by legislative appropriations, the school acted "on behalf of" the state. This argument is not persuasive either.

In *Shamberg*, the court concluded that the words "on behalf of" meant bonds issued by a state authority to carry out a public purpose where the latter is not named as an obligor. 144 F.2d at 1006. In that case, however, once having found that the Port Authority was a political subdivision, the court has no need to explore to any extent the application of the "on behalf of" clause.

3. The Tax Court, in The Seagrave Corp., 38 T.C. 247 (1962), found that volunteer fire companies were not subdivisions of the state even though they perform a "public function." Public service was insufficient to transform an otherwise private corporation into an arm of the state when "[t]hey were not created by any special statutes and they received no delegation of any part of the State's power." *Id.* at 250. *See also* Rev. Rul. 77-232.

In *White's Estate*, the court referred to the Authority as the "alter ego" of the city, especially noting that on redemption of the obligations, title to the bridge would revert to the City of New York. In view of this, "[t]o distinguish between such an agency and the city in regard to the [tax] exemption seems to us purely technical." 144 F.2d at 1021.

Again, the distinctions between the *Shamberg-White* situations and Temple's are illuminating. In the former, the obligations were to defer, in the main, the cost of capital improvements which would either go to a governmental unit or would be available to the public for governmental purposes. Had the Authorities not paid for the projects, the state or city would have been required to do so.

Here, on the other hand, the loans were used for current operating expenses, not capital projects. The state was not the sole source of revenue, because much of the school's operating expenses came from its own resources, such as tuition and other private means. In the years when the university received less than its requested appropriation, it had to secure additional funds from other available sources — just as it did in the era before the Commonwealth Act became effective.

In the years when the appropriations were late, the university had to borrow. Although legislative delays caused unnecessary hardship to the university, there was no legal obligation on the Commonwealth to appropriate any particular sum in a given year. The Act itself permits Temple to set fee schedules when insufficient appropriations are made. Thus, when state funds were not forthcoming, Temple was thrown back upon its own resources like other private institutions. The interest on money borrowed because of the legislature's delay was simply another operating expense, which reduced the funds avail-

able for educational purposes. It was unfortunate for the school and should not have happened, but even so, Temple acted only on its own behalf, not that of the state.

The Treasury regulation explains that obligations issued "on behalf of" a state or a local governmental unit "by constituted authorities empowered to issue such obligations are the obligations of such a unit." 26 C.F.R. § 1.103-1(b). Many states and municipalities have established authorities to construct and maintain governmental facilities when debt limits imposed by state constitutions or statutes would not permit financing by the governmental unit itself. *See, e.g.*, 53 PA. STAT. ANN. § 306(A) (Purdon Supp. 1981) (Pennsylvania Municipal Authorities Act). In that situation, the duly "constituted authority" is a wholly governmentally controlled entity, performing a wholly governmental function, and it is created to be in effect the alter ego of the governmental unit. Under the regulations, bonds issued by the Authority would be considered issued on behalf of the state.

No such identity of interest, control, or intent, however, exists between Temple and the Commonwealth of Pennsylvania. Nor is there any language in the Commonwealth Act that purports to make Temple the alter ego of the state. The wording of the statute itself and the opinion of the Pennsylvania Supreme Court in *Mooney* make that apparent. We cannot say, therefore, that Temple issued its obligation "on behalf of" the Commonwealth of Pennsylvania.

Section 103 has been amended by Congress in recent years to include specifically bonds for industrial development, and obligations issued for construction of such diverse structures as residential units, sports arenas, convention halls, waste disposal plants, air or water pollution control facilities, and other similar projects. The fact that Congress has "fine-tuned" the tax exemption section by

defining the status of many different types of bonds suggests that a liberal definition of "political subdivision" is not warranted here.

Whether to grant or withhold an exemption for the obligations of various kinds of entities has become a matter for Congress to decide on a policy basis, rather than on the concerns expressed in 1913 that a federal tax on state obligations would be unconstitutional. *Cf. Commissioner v. Shamberg's Estate*, 144 F.2d at 1004. If the interest on obligations of state-related schools is to be exempt from federal tax, that decision should be made by Congress, not by this court via a strained construction of the statute.

In summary, we conclude that Temple was neither a "political subdivision" of the state, nor an entity constituted to issue bonds "on behalf of" the State of Pennsylvania. Accordingly, the interest paid on the school's obligation was not tax exempt, and the judgment in favor of the bank will be vacated. The case will be remanded to the district court with instructions to enter judgment in favor of the United States.

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 79-941

PHILADELPHIA NATIONAL BANK

v.

UNITED STATES OF AMERICA

FINDINGS OF FACT AND CONCLUSIONS OF LAW

NEWCOMER, *J.* December 8, 1980.

In the years 1967 through 1971, Temple University, located in Philadelphia, Pennsylvania was required to borrow funds from the plaintiff, Philadelphia National Bank, because certain appropriations to the University made by the Commonwealth of Pennsylvania were slow in coming. Philadelphia National Bank has sued for a refund of the income taxes that it paid on the loan interest paid to it by Temple, arguing that the interest paid by Temple should be treated as "interest on . . . the obligations of a state . . . or [a] political subdivision of [a state]", and therefore exempt from taxation under § 103(a)(1) of the Internal Revenue Code. 26 U.S.C. § 103(a)(1). After trial of the matter the Court has determined that the plaintiff is entitled to the refund it seeks.

FINDINGS OF FACT

Few facts are in dispute, and the parties have stipulated to Findings 1 through 75 that follow:

1. Philadelphia National Bank is a national banking association organized and existing under the laws of the United States, with its principal place of business located in Suburban Square, Montgomery Avenue, Ardmore, Pennsylvania 19003.

2. Philadelphia National Corporation is a bank holding company organized and existing under the laws of Pennsylvania with its principal place of business located in Philadelphia, Pennsylvania 19101.

3. In 1969, Philadelphia National Corporation acquired ownership of Philadelphia National Bank and for 1969 and subsequent years, Philadelphia National Corporation filed a consolidated federal income tax return on behalf of itself and its consolidated subsidiaries, including Philadelphia National Bank.

4. Temple University — Of The Commonwealth System of Higher Education ("Temple University") is a fully accredited institution of higher education initially organized in 1888 under the non-profit corporation provisions of the Act of April 29, 1874, as The Temple College of Philadelphia and reorganized pursuant to the Temple University — Commonwealth Act of November 30, 1965, P.L. 843, 24 P.S. §§ 2510-1 *et seq.* (1979-80 Pocket Part) (the "Commonwealth Act").

5. The main campus of Temple University is and was during the years at issue at Broad Street and Montgomery Avenue, Philadelphia, Pennsylvania.

6. During these same years, in addition to the main campus, Temple University had campuses at Broad and Ontario Streets in North Philadelphia, Elkins Park, and Ambler, Pennsylvania.

7. Temple University's student enrollment was approximately 30,000 in the period 1966 through 1971.

8. During the years 1967 through 1971, Temple University had the following undergraduate and graduate schools: Liberal Arts, Education, Business Administration, Social Administration, Communications and Theatre, Music, Law, Pharmacy, Allied Health Professions, Medical, Tyler School of Art, Technical Institute.

9. During the years in question, the number of full and part-time faculty at Temple University ranged between 2361 and 2909.

10. This Court has jurisdiction over this matter, which involves a dispute over the amount of Plaintiffs' Federal Income tax liability, under 28 U.S.C. § 1346(a)(1), 28 U.S.C. § 1331(a), and 28 U.S.C. § 1340.

11. Venue is proper in this district under 28 U.S.C. § 1391(a), as that in which Plaintiffs reside and the claim arose.

12. In the normal course of its banking business, Philadelphia National Bank made loans to Temple University, which loans were evidenced by interest-bearing obligations issued by Temple University to Philadelphia National Bank.

13. During the years 1967 through 1971, Temple University paid principal and interest to Philadelphia National Bank on two seven-year term loans (one of $550,000 and the other of $250,000) and on approximately 138 short-term (30-90 day) and demand obligations.

14. Temple University used the proceeds from the $550,000 term loan and the proceeds from the approximately 138 short term and demand loans in the normal course of its charitable and educational activities to pay operating expenses. Proceeds from the $250,000 term loan were used to redeem 4% debenture bonds.

15. The aforesaid borrowings were incurred due to insufficient appropriations to Temple University from the Commonwealth of Pennsylvania or the Commonwealth's delay in paying to the University amounts already appropriated.

16. Philadelphia National Bank accrued interest on its loans to Temple University described in paragraph 13 above in the following amounts:

Year	*Interest Accrued*
1967	$ 41,930
1968	46,080
1969	237,600
1970	237,908
1971	390,593

17. Philadelphia included the said interest in their federal income tax returns and paid tax thereon in the following amounts:

Year	*Amount*
1967	$ 20,083
1968	24,330
1969	125,453
1970	117,051
1971	187,485

18. Plaintiffs timely filed claims for refund with the district director of Internal Revenue of their 1967 through 1971 federal income tax in the following amounts:

Year	*Amount*
1967	$ 20,083
1968	24,330
1969	125,453
1970	117,051
1971	187,485

19. The basis of plaintiffs' claims for refund is that interest paid by Temple University to Philadelphia National Bank is free from federal income tax under section 103 of the Internal Revenue Code of 1954.

20. The district director of Internal Revenue denied plaintiffs' claims for refund for the years 1967 through 1971.

21. This suit was timely filed under section 6532 (a)(1) of the Internal Revenue Code of 1954.

22. If judgment is entered in favor of plaintiffs in this case they will be entitled to receive from defendant a total refund equal to the overpayment of tax, plus deficiency interest paid, plus statutory interest thereon.

23. The Temple University-Commonwealth Act (24 P.S. § 2510-1 et seq.), which was enacted by the Commonwealth of Pennsylvania and made effective July 1, 1965, made significant and material changes in Temple University's relationship with the Commonwealth.

24. Upon the passage of the Temple University-Commonwealth Act the University's name was changed from Temple University to Temple University — Of The Commonwealth System of Higher Education.

25. The "Report of the Higher Education Committee, House of Representatives, Commonwealth of Pennsyl-

vania, 1965-1966", sets forth reasons for the passage of the Temple University — Commonwealth Act.

26. The Report of the Higher Education Committee states at page 34 that Temple University is to be the Commonwealth's instrumentality to implement the Commonwealth's higher education policies in southeastern Pennsylvania.

27. The Report of the Higher Education Committee states at page 35:

> Temple University is designated by the Commonwealth Act as a 'state-related institution in the Commonwealth System of Higher Education.' In practical effect, this means that the organic relationship between Temple University and the Commonwealth is now the same as that between the Commonwealth and the Pennsylvania State University.

28. An important Commonwealth purpose for enacting the Temple University-Commonwealth Act was to satisfy Pennsylvania's constitutional obligation to advance public education (Pennsylvania Constitution, Article III, Section 14) by increasing college enrollment among residents of southeastern Pennsylvania and reducing their tuition costs without incurring the much greater cost to the Commonwealth of Pennsylvania of establishing and constructing a new public university.

29. As the result of the passage of the Temple University — Commonwealth Act, the University's Board of Trustees was reconstituted to consist of 36 regular members, together with the Governor of the Commonwealth of Pennsylvania, the Superintendent of the Department of Public Instruction, (now the Secretary of Education of the Commonwealth of Pennsylvania) and the Mayor of the

City of Philadelphia, all three of whom are trustees *ex officio*. Twelve of the 36 regular trustees are Commonwealth trustees, four of whom are appointed by the Governor, four by the President *pro tempore* of the Pennsylvania Senate, and four by the Speaker of the Pennsylvania House of Representatives.

30. Section 5 of the Temple University — Commonwealth Act provides that the management and control of the instructional, administrative, and financial affairs of the University are vested in the Board of Trustees, and the Board exercises those powers.

31. Under the University's by-laws, 12 voting members of the Board of Trustees constitute a quorum.

32. Section 6 of the Temple University — Commonweath Act, provides in effect for the maintenance of a lower tuition and fee schedule rate for Pennsylvania residents attending the University. In exchange for this benefit, the Commonwealth annually must appropriate sums of money to operate the University. Through the annual appropriation process, the Commonwealth of Pennsylvania distributes general fund revenues to the University.

33. Pursuant to statutory authority, in 1966, the Auditor General promulgated "rules Governing the Determination of Students' Pennsylvania Resident Status". The residency rules were amended in 1967. These residency rules applied to Temple University and the Pennsylvania State University.

34. During the years indicated, the Commonwealth appropriated to the University the amounts indicated below. Also indicated are the percentages those appropriations represented as a part of current unrestricted revenues of the University (exclusive of the Temple University Hospital).

Year	*Commonwealth Appropriation for Educational and General Purposes*	*Commonwealth Appropriation as a Percent of Current Unrestricted Revenue*
1966-67	$20,106,998	50.6%
1967-68	28,061,146	60.9
1968-68	33,440,567	62.4
1969-70	41,392,000	62.7
1970-71	41,392,000	56.5
1971-72	44,568,000	56.1

35. Annual appropriation acts of the Commonwealth of Pennsylvania (a) set forth the total annual appropriation to the University, with amounts appropriated for specific, broad categories, (b) establish a schedule for payments of the appropriation during the year, and (c) require the University to report to the Commonwealth regarding its expenditure of the appropriation. Annual appropriation acts have also specified the tuition rates to be charged to students by the University.

36. Section 8 of the Temple University — Commonwealth Act requires the University to submit certified payrolls and expenditure vouchers to the Commonwealth of Pennsylvania in order to obtain appropriation payments.

37. At the end of each fiscal year, the University is required by Pennsylvania law to file a statement with the Pennsylvania General Assembly and the Auditor General of the Commonwealth showing the amounts and purposes of all University expenditures during the prior year.

38. The Auditor General annually reviews the University's books and has the right to disallow any expenditure of funds appropriated by the Commonwealth for purposes not permitted by appropriation act and to cause such

disallowed sum to be recovered and paid by the University to the Treasurer of the Commonwealth.

39. Section 10 of the Temple University — Commonwealth Act requires the President of the University to report annually to the Governor and the General Assembly on the activities of the University.

40. Section 9 of the Temple University — Commonwealth Act authorizes the University's Board of Trustees to issue bonds in the name of the University. Such bonds, and loans secured by mortgages, their transfer and the income therefrom are declared by law to be free from tax within the Commonwealth of Pennsylvania.

41. Beginning in the 1969-1970 fiscal year, the University's short-term borrowings increased substantially as a result of the delay in payment of the Commonwealth's annual appropriation.

42. Section 7 of the Temple University — Commonwealth Act specifies that the Commonwealth's capital development programs are available to the University under terms comparable to those applicable to land grant institutions of higher learning and state colleges.

43. During the years 1967 through 1971 the General State Authority of the Commonwealth of Pennsylvania engaged in at least nine building projects on behalf of the University.

44. During the years 1967 through 1971, to initiate a building project, the University would designate the land to be acquired by the General State Authority, the use of the building to be constructed by the General State Authority, and the building's estimated cost.

45. During the years at issue, the General State Authority, approved every such designation by the Uni-

versity of land to be acquired by the General State Authority for the University's benefit.

46. The projects constructed by the General State Authority for the University during 1967 through 1971 included the Psychology Building; Humanities Building; Clinical Teaching Building and Expansion of Out-Patient Facility; Social Sciences Building; Pharmacy, Nursing and Allied Health Sciences Center; Health Sciences Building; Law Center; School of Technology Building; and Computer Center.

47. At the behest of the University, the General State Authority acquired a portion of the land for five projects (Humanities Building, Clinical Teaching Building and Expansion of Out-Patient Facility, Social Sciences Building, Health Sciences Building, and School of Technology Building) by condemning a total of 97 individual properties.

48. The General State Authority acquired land for the other four projects by deed from the University. The consideration for three of such deeds was $1 and for the fourth $7,748.40.

49. By June 30, 1971, the Commonwealth of Pennsylvania had financed and owned $54,482,141 of the land, buildings, and equipment then used by the University, or nearly 40% of the University's total physical plant.

50. As of June 30, 1971, the Commonwealth of Pennsylvania had approved the expenditure of an additional $79,000,000 in Commonwealth funds for the construction of additional facilities for the University.

51. By June 30, 1979, the Commonwealth of Pennsylvania had financed and owed $157,121,000 of the land, buildings, and equipment used by the University, or 57% of the University's total physical plant.

52. The relationship between the Commonwealth of Pennsylvania and the University is such that the Commonwealth charges the University nothing for the use of facilities constructed by the Commonwealth and has no written lease or other agreement with the University for their use.

53. Under the Act of July 7, 1968, P.L. 297, No. 149, 71 P.S. § 646 (1979-80 Pocket Part), the University's police force is authorized "to exercise the same powers as are now or may hereafter be exercised under authority of law or ordinance by the police of the Cities of Harrisburg, Pittsburgh, and Philadelphia . . . ."

54. The University's campus police force possesses many statutory powers, including the power to arrest on the University's property, to investigate calls and complaints, to control demonstrations and strikes, and to patrol the grounds.

55. The training of the University's campus police force includes annual qualification on the firing range and courses in first aid, violent crimes, psychology, and crowd control.

56. Temple University's campus police force is uniformed and armed, and during the years at issue there were up to 140-150 full time members.

57. Temple University is designated by statute as an instrumentality of the Commonwealth of Pennsylvania and therefore is exempt from Pennsylvania Sales and Use Tax.

58. Temple University is designated by statute as an instrumentality of the Commonwealth of Pennsylvania and therefore is exempt from Pennsylvania Realty Transfer Tax.

59. Temple University is designated by statute as an instrumentality of the Commonwealth of Pennsylvania and

therefore is exempt from Pennsylvania Liquid Fuels and Use Tax.

60. The National Labor Relations Board has declined to exercise jurisdiction over Temple University's employees because the University is a "quasi-public institution".

61. Temple University is designated by statute as an instrumentality of the Commonwealth of Pennsylvania, and therefore is exempt from the requirement of posting security in state court injunction proceedings.

62. Article III, Section 14 of the Pennsylvania Constitution of 1968 states: "The General Assembly shall provide for the maintenance and support of a thorough and efficient system of public education to serve the needs of the Commonwealth".

63. The Commonwealth of Pennsylvania has delegated to Temple University the essential governmental function of providing higher public education in southeastern Pennsylvania.

64. The findings of facts beginning on page 475 and ending on page 484 of Judge Higginbotham's opinion in *Isaacs v. Board of Trustees of Temple University — Of The Commonwealth System of Higher Education*, 385 F.Supp. 473 (E.D. Pa. 1974), are adopted for purposes of this case.

65. The Board of Trustees of the Pennsylvania State University ("Penn State") is composed of 32 members, five of whom are *ex officio* and include the President of Pennsylvania State University ("Penn State"), the Governor of Pennsylvania, and three members of his cabinet. Six members are appointed by the Governor with the consent of the Pennsylvania Senate. Of the remaining 21 trustees, nine are elected by the Penn State alumni asso-

ciation and 12 by members of county agricultural and industrial societies of Pennsylvania.

66. During the years indicated the Commonwealth of Pennsylvania appropriated to Penn State the amounts indicated below. Also indicated are the percentages those appropriations represented as a part of current unrestricted revenues of Penn State.

Year	*Appropriation From Commonwealth*	*Appropriation as a % of Revenue*
1966	$31,135,000	32.0%
1967	41,209,000	35.8
1968	50,239,000	37.6
1969	61,357,000	40.1
1970	72,217,000	41.6
1971	72,049,000	38.4
1972	79,660,000	36.3

67. The Commonwealth of Pennsylvania provides the same capital development program to Penn State as it does to Temple University.

68. By the end of Penn State's 1971 fiscal year, the Commonwealth of Pennsylvania had financed and owned $81,393,000 of the land, buildings and equipment used by Penn State, or nearly 25% of Penn State's total land, buildings, and equipment.

69. Penn State lacks the sovereign power to tax.

70. Penn State has police and eminent domain powers substantially equivalent to those of Temple University.

71. Penn State cannot pledge the credit of the Commonwealth.

72. On November 10, 1955, the Internal Revenue Service issued a private letter ruling stating that interest

on Penn State's indebtedness incurred pending the receipt of appropriations from the Commonwealth of Pennsylvania was free from Federal income tax since "any notes or other obligations issued by the University for the above-stated purpose are to be regarded as instrumentalities [sic] of the State of Pennsylvania."

73. On February 5, 1957, the Internal Revenue Service issued a private letter ruling stating that interest paid on first mortgage bonds issued by Penn State is free from Federal income tax under section 103 of the Code.

74. Some of the obligations issued by Penn State on the basis of said rulings of the Internal Revenue Service remain outstanding.

75. The Internal Revenue Service has neither revoked nor revised either of the Penn State rulings.

In addition the Court finds that:

76. The Temple University Police Force is employed by the University and paid by the University. (N.T. 38)

77. Temple University has the authority to issue rules and regulations governing conduct on campus and can impose fines or suspend students for violations of these rules. (N.T. 40)

78. Temple University could not function without state appropriations, and it actively seeks to influence the levels of appropriations made by the state legislature.

79. When Commonwealth appropriations were delayed or inadequate Temple was required to borrow money from the plaintiff. The interest it was required to pay on these loans was passed on to the Commonwealth during the appropriations process. (N.T. 55-6).

CONCLUSIONS OF LAW

I.

Section 103 of the Internal Revenue Code excludes from taxation that income that a taxpayer earns in the form of interest paid by a state on its obligations. The statute reads in pertinent part as follows:

> "§ 103(a) GENERAL RULE — Gross income does not include interest on —
>
> (1) the obligations of a State, a territory or a possession of the United States or any political subdivision of any of the foregoing, or of the District of Columbia. . . ."

The pertinent Treasury Regulations expand the meaning of § 103(a)(1):

> "(a) Interest upon obligations of a State . . . or any political subdivision (hereinafter collectively or individually referred to as 'State or local governmental unit') is not includable in gross income. . .
>
> (b) Obligations issued by or on behalf of any state or local governmental unit by constituted authorities impowered to issue such obligations are the obligations of such a unit. . . . *The term 'political subdivision' for purposes of this section denotes any division of any state or local governmental unit which* is a municipal corporation or *which has been delegated the right to exercise part of the sovereign power of the unit.* As thus defined, a political subdivision of any state or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation drainage, innigation, level, school, harbor, port improvement and similar districts and divisions of any such unit.

Tres. Reg. § 1.103-1 (29 C.F.R. § 1.103-1) (emphasis supplied).

Regulation § 1.103-1 codifies two early opinions by United States Attorneys General and the holding of *Commissioner v. Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944), *cert. denied*, 333 U.S. 79 (1945). The first of the two administrative opinions was issued in 1914 by Attorney General (later Justice) James C. McReynolds, interpreting Section 2(b) of the Revenue Act of 1913, the predecessor of Section 103. Mr. McReynolds wrote:

> "The term 'political subdivision' is broad and comprehensive and denotes any division of the state made by the proper authorities thereof, acting within their constitutional powers, for the purposes of carrying out a portion of those functions of the State which by long usage and the inherent necessities of government have always been regarded as public. The words 'political' and 'public' are synonymous in this connection. (Dillon Municipal Corporations, 3rd, Sec. 34). It is not necessary that such legally constituted 'division' should exercise all the functions of the state of this character. It is sufficient if it be authorized to exercise a portion of them.

30 Op. Atty. Gen. (1914), p. 252.

In 1937, Attorney General Homer Cummings reiterated that the definition of 'political subdivision' included more than traditionally recognized governmental entities.

> The term 'political subdivision' may be used in statutes in more than one sense. It may designate a true governmental subdivision such as a county, township, etc. or it may have a broader meaning denoting any subdivision of the state created for a public purpose although authorized to exercise a portion of the sovereign power of the state only to a limited degree.

38 Op. Atty. Gen. (1937), p. 563.

In *Commissioner v. Shamberg's Estate, supra,* the Second Circuit relied on both the McReynolds and Cummings opinions in holding that interest on obligations of the Port of New York Authority was not subject to federal income taxation. The Court also added a useful refinement to the earlier tests by focusing on the traditional powers of state and local government.

The court in *Shamberg* also stressed that an examination of the *purpose* of the entity is perhaps the crucial factor in determining whether it is a governmental unit for purposes of § 103:

> "When [the Treasury Regulation] gave immunity to bonds issued 'on behalf of' the state as well as those issued by the state itself, those words certainly meant something in addition to the words 'issued by' and what can the added words refer to except bonds issued by a state agency to carry out a public purpose . . ."

144 F.2d at 1006.

In *Commissioner v. Estate of White,* 144 F.2d 1019 (2d Cir. 1944), *cert. denied,* 323 U.S. 792 (1945), a companion case to *Shamberg,* the Second Circuit held that interest on obligations of the Triborough Bridge Authority was tax-free under § 103. The Court explained the reasons for exempting the obligations of certain state agencies, as well as those of states and municipalities themselves:

> "The reason for the exemption of course was to free the states from the burden of income taxes on their investments in enterprises for the public welfare. It can make no difference whether the city or its alter ego is liable. *In either case the burden would be upon a governmental activity* and that is the substance

> of the grievance both of the Authority and of the taxpayer."

144 F.2d at 1021 (emphasis added).

The Internal Revenue Service used an analysis similar to that employed in *Shamberg* and *White, supra,* in Revenue Ruling 73-563, 1973-2 C.B. 24. At issue in that Ruling was whether the interest paid by a rapid transit authority was to be tax exempt under § 103. The IRS ruled that the transit authority, created by an act of the state legislature to plan, acquire, finance, maintain, and administer a rapid transit system, qualified as a political subdivision of the state under § 103. Citing *Shamberg,* the IRS considered whether the authority possessed any of the three generally recognized sovereign powers — the police power, the power to tax, or the power of eminent domain — and determine that the authority effectively exercised all three. The IRS found the authority's police power in its power to set rates, determine routes, and enforce its regulations by means of a security force. The Ruling treated the power to tax and the power of eminent domain as follows:

> [a]lthough the authority in the instant case is not authorized to exercise directly the power to tax and the power of eminent domain, the state legislature has conferred the benefit of such powers on the authority by providing channels through which such powers may be exercised by the participating local governmental bodies to assist the authority.

The IRS ruled that the "authority [had] been granted a sufficient portion of the sovereign powers of the state to perform the essential governmental function for which it was created," and qualified as a political subdivision under § 103.

II.

Having considered the arguments of the parties, the authorities cited by both sides and the facts at hand, most of which are not in dispute, the Court concludes that the interest paid by Temple University or the obligations at issue is exempt from federal income taxation under § 103.

Temple University is the "instrumentality of the Commonwealth" for implementing Pennsylvania's policies for higher education in southeastern Pennsylvania. (See Findings 26-28, *supra*). It *exercises* (even if it might not be said to "possess") every significant sovereign power necessary to effectuate that purpose.

Temple, like most large universities, is a small city in itself. It empowers and maintains a police force which is empowered by state statute to enforce the laws of Pennsylvania and the regulations promulgated by the University. The police force "exercise[s] the same powers as are now or may hereafter be exercised under authority of law or ordinance by the police of the cities of Harrisburg, Pittsburgh and Philadelphia . . ." Act of July 7, 1968, P.L. 297, No. 149, 71 P.S. § 646 (1979-80). The University also sets and enforces rules of conduct for its students and, of course, it creates and administers its own instructional policies. In short, the University, through its Board of Trustees, its faculty, and its staff, creates and implements various policies for the public welfare. It possesses and exercises a *part* of the police power in much the same way that the Port Authority of New York and New Jersey does. *See Shamberg's Estate, supra.*

Temple does not have the power to tax. It does, however, charge tuition in exchange for providing a recognized public service which is optional to its users; in that respect it operates much like a state owned toll road or certain types of special assessment districts. What is more

important, however, is that the state annually uses its power to tax and appropriate funds on Temple's behalf. Temple must account to the state for the funds, and, through requests made to the state legislature, influences the amounts appropriated. Like the transit authority under consideration in Revenue Ruling 73-563, *supra.*, "the state has conferred the benefit of [the power to tax] by providing channels through which such powers may be exercised . . . to assist" the university.

Such "assistance" is even more striking in the case of the power of eminent domain. Section 7 of the Temple University Commonwealth Act makes available to Temple "[t]he benefits of all Commonwealth or Commonwealth authority programs for capital development and improvement." 24 P.S. § 2510-7. The General State Authority of the Commonwealth of Pennsylvania ["GSA"], the state agency responsible for the construction of state facilities during the time in question, exercised its power of eminent domain for Temple's benefit on numerous occasions. (See Findings 43-52, *supra.*). Indeed, the GSA never refused a University request to exercise the power of eminent domain. Temple normally designates the form and location of the building, and the GSA acquires the property (exercising its power of eminent domain if necessary), finances the construction of the facility, and then simply gives the building to the University. Unlike the transit authority at issue in Revenue Ruling 73-563, Temple is not even obliged to pay for the cost of acquisition of the property.[1]

1. The Court's conclusion that Temple qualifies for the § 103 exemption is further supported by Pennsylvania State University's status under § 103. The parties have stipulated, that Temple and Penn State are essentially identical in their relationship to the Commonwealth. The I.R.S. has issued two private letter rulings (one on November 10, 1955 and another on February 5, 1957)

CONCLUSION

As states devise increasingly ingenious mechanisms for carrying out public purposes, and indeed for combining public and private purposes, it becomes more difficult to determine what obligations are issued "on behalf of" the state by a "political subdivision" of the state, but Temple University *is* a political subdivision in many respects.

1. (continued)

stating that Penn State's interest payments are exempt from federal income taxation under § 103. While an individual may not rely on private letter rulings issued to another taxpayer, "such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws." Hanover Bank v. Commissioner, 369 U.S. 672, 686 (1962). The Court need not find that the private letter rulings are controlling given all the other reasons for finding Temple's interest payments exempt under § 103. However, the Court has considered the IRS's interpretation of the statute as it is reflected in those rulings, which have not been revoked or revised. The IRS has suggested that the private letter rulings issued to Penn State do not reflect their current position on whether a state university qualifies for the § 103 exemption and opposed the suggestion that there ought to be a rational basis for treating similarly situated taxpayers differently. United States v. Kaiser, 363 U.S. 299 at 360, (1960). The Court cannot see any reason why Temple should be treated differently from Penn State.

Having suggested that the private letter rulings do not reflect the agency's current position with respect to state universities, the I.R.S. argued that the agency's current position is reflected in Revenue Ruling 77-165. In that Ruling a state university which "[did] not possess a substantial right to exercise the power to tax, the power of eminent domain, or police power," did not qualify as a political subdivision under § 103. Because the Court does not believe that the university under consideration in that Ruling effectuated, possessed or exercised the powers or public purposes that are exercised by Penn State and Temple, it does not consider the Ruling to be controlling here, even if it may be presumed to state the law accurately.

Like the public school districts that have been in existence as political subdivisions for many decades, Temple is a political subdivision in a modern form. More important, however, is Temple's status as an *instrumentality* of the state. When Temple borrows it borrows in large measure "on behalf of" the Commonwealth of Pennsylvania. Section 103 is designed to exempt from taxation the interest on exactly that sort of obligation.

Accordingly, judgment will be entered for the plaintiff.

Clarence C. Newcomer, *J.*

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 79-941

PHILADELPHIA NATIONAL BANK

v.

UNITED STATES OF AMERICA

ORDER

[Filed December 8, 1980]

AND NOW, to wit, this day of December, 1980, judgment is hereby entered in favor of the plaintiff and against the defendant in the amount of $474,402.00.

AND IT SO ORDERED.

Clarence C. Newcomer, J.

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION No. 79-0941

PHILADELPHIA NATIONAL BANK, et al.

v.

UNITED STATES OF AMERICA

ORDER

[Filed January 25, 1982]

AND Now, this 22nd day of January, 1982, it is hereby Ordered that, consistent with the mandate of the Court of Appeals, judgment is entered for defendant and against plaintiff.

AND IT IS SO ORDERED.

/s/ CLARENCE C. NEWCOMER
Clarence C. Newcomer, J.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1331

PHILADELPHIA NATIONAL BANK and
PHILADELPHIA NATIONAL CORPORATION

v.

UNITED STATES OF AMERICA,
Appellant

(D.C. Civil No. 79-0941)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

Present: HUNTER, ROSENN and WEIS, *Circuit Judges*

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel on October 14, 1981.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said Dis-

trict Court, entered December 8, 1980, be, and the same is hereby vacated and the cause remanded for the entry of judgment in favor of the United States of America.

ATTEST:

/s/ SALLY MRVOS
Clerk

December 11, 1981

Certified as a true copy and issued in lieu of a formal mandate on January 4, 1982.
Test:

M. Elizabeth Ferguson

Chief Deputy Clerk, United States Court of Appeals for the Third Circuit

26 CFR 1.103-1: INTEREST UPON OBLIGATIONS OF A STATE, TERRITORY, ETC.

Rapid Transit authority. A rapid transit authority created by an act of the State legislature and empowered to issue bonds, exercise police powers, and realize the benefits of taxes imposed and the power of eminent domain exercised by participating local governmental bodies, qualifies as a political subdivision of the State within the meaning of section 1.103-1 of the regulations.

Rev. Rul. 73-563

Advice has been requested whether, under the circumstances described below, a rapid transit authority (authority) qualifies as a political subdivision of a state.

The authority, a public corporation, was created by an act of the State legislature to plan, acquire, finance, maintain and administer a rapid transit system within a specific geographic area encompassing several participating counties. The development of a mass transit system by the authority is declared to be an essential governmental function by the State constitution.

The governing body of the authority is the Board of Directors that is comprised of members appointed by each of the participating local governmental bodies.

The authority is empowered to hold public hearings and, on the basis of such hearings, to set rates for the rapid transit system and to determine what routes it will serve. The authority is not subject to the jurisdiction of the State Public Service Commission.

The authority is authorized to contract for, or provide and maintain, a security force to preserve and protect the facilities and property owned or operated by the authority within the territory served by the transit system and to preserve and protect the public peace, health, and safety.

The authority has the power to issue bonds and other evidences of indebtedness the payment of which is secured by a pledge of its revenues. Such obligations are not deemed to be obligations of any of the participating local governments. The interest on such obligations is exempt from all taxation within the State. The properties of the authority and its income are exempt from any State or local tax.

The authority does not have the power of eminent domain but the participating governing bodies may, for purposes of the authority, exercise the broadest power of eminent domain available to them and convey property so acquired to the authority for the cost of acquisition.

The authority has no power to impose any tax. However, the Act provides for financial participation between the authority and the local governments by authorizing the local governments to levy a retail sales and use tax which is to be used to finance the operation of the transit system.

Section 1.103-1 of the Income Tax Regulations provides, in part, that the term "political subdivision" denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

Three generally recognized sovereign powers of states are the police power, the power to tax, and the power of eminent domain. See *Alexander J. Shamberg*, 3 T.C. 131, (1944) acq., 1945 C.B. 6, *aff'd*, 144 F.2d 998 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1944).

Although the authority in the instant case is not authorized to exercise directly the power to tax and the power of eminent domain, the State legislature has conferred the benefit of such powers on the authority by providing channels through which such powers may be

exercised by the participating local governmental bodies to assist the authority.

In *Alexander J. Shamberg* it was held that State police powers include the power to promulgate and enforce transportation regulations. Since the authority in the instant case has the power to set rates, determine routes, and enforce its regulations by maintaining a security force, it is considered to possess police powers. Thus, the authority has been granted a sufficient portion of the sovereign powers of the State to perform the essential governmental function for which it was created.

Accordingly, in this case, the authority qualifies as a political subdivision of the State within the meaning of section 1.103-1 of the regulations.

LETTER RULING TO PENNSYLVANIA STATE UNIVERSITY DATED NOVEMBER 10, 1955

U. S. TREASURY DEPARTMENT
Washington 25

Office of
Commissioner of Internal Revenue

Address Reply to
Commissioner of Internal Revenue
And Refer to
T:R:C:
AHB

Nov. 10, 1955

Mr. S. K. Hostetter, Comptroller
The Pennsylvania State University
University Park, Pennsylvania:

Dear Mr. Hostetter:

This is in reply to your letter of October 14, 1955, requesting a ruling as to whether or not interest paid on certain loan made to the University will be exempt for Federal income tax purposes. The information furnished is briefly stated as follows:

The Pennsylvania State University is the land grant university of Pennsylvania. It is an instrumentality of the Commonwealth of Pennsylvania performing the essential governmental function of education, and is supported by appropriations of funds by the legislature.

The fiscal year of the Commonwealth of Pennsylvania ended on May 1, 1955, and the University on June 30, 1955. Inasmuch as no appropriations have been passed by the legislature or approved by the Governor for the next fiscal year, it will be necessary for you to borrow money. The money so borrowed will be repaid, together with interest thereon, with the funds that are eventually appropriated by the legislature.

Section 103(a)(1) of the Internal Revenue Code of 1954 provides, among other things, that gross income does not include interest on the obligations of a State or any political subdivision thereof.

Section 39.22(b)(a)-1 of Regulations 118 (see T.D. 6091, Cumulative Bulletin 1954-2, page 47) provides in part:

> "* * * Obligations issued by or or behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof.* * *"

Based on the above-stated information, it is the opinion of this office that any notes or other obligations issued by the University for the above-stated purpose are to be regarded as instrumentalities of the State of Pennsylvania. Accordingly, the interest on such obligations will be excludable from the gross income of the recipient for Federal income tax purposes pursuant to the terms of section 103(a)(1) of the Internal Revenue Code of 1954.

Very truly yours,

Director, Tax Rulings Division

LETTER RULING TO PENNSYLVANIA STATE UNIVERSITY DATED FEBRUARY 23, 1957

U. S. TREASURY DEPARTMENT
Washington 25

Office of
Commissioner of Internal Revenue

Address Reply to
Commissioner of Internal Revenue
And Refer to
T:R:C:
AHB

Feb. 23, 1957

Mr. S. K. Hostetter, Treasurer
The Pennsylvania State University
University Park, Pennsylvania

Dear Mr. Hostetter:

This is in reply to your letter of February 1, 1957, requesting that a ruling be issued under section 103 of the Internal Revenue Code of 1954 to the effect that interest paid on certain Mortgage Bonds to be issued by your corporation (hereinafter referred to as the "University") will be exempt for Federal income tax purposes. The information furnished by you is briefly stated as follows:

The University is a nonprofit corporation which was created and organized by the Commonwealth of Pennsylvania for the education of youth in the various branches of science, learning, and practical agriculture and, as an instrumentality of said Commonwealth, to perform the essential governmental function of education, has been designated as the Land Grant institution of said Commonwealth.

The proposed First Mortgage Bonds will be issued under an Indenture of Mortgage and Deed of Trust to be entered into by the University and Mellon National Bank and Trust Company, as Trustee, and will be secured by a first mortgage on certain dormitories, dining halls, and related facilities and by a pledge of the gross revenues thereof. The First Mortgage Bonds will be unlimited in amount and will be issuable from time to time in series. You enclosed a copy of the most recent proof of the Indenture.

At this time the University intends to issue a series of the First Mortgage Bonds to be designated the Series A Bonds and to be in aggregate principal amount of $22,600,000. The University proposes to deliver $11,800,000.00 of such bonds, together with certain cash, to the State Employees' Retirement Board, a departmental administrative board under the jurisdiction of the Department of State of the Commonwealth of Pennsylvania, in discharge of certain indebtedness of the University to said Board, of which the present unpaid amount is $13,800,000.00. The University proposes to sell the remaining $10,800,000.00 principal amount of the Series A Bonds to the public through underwriters.

The proceeds of the indebtedness retired were, and the proceeds of the Series A Bonds to be sold to the public at this time will be, applied by the University in payment of the cost of the construction of dormitories, dining halls, and related facilities.

It is stated that, subject to the conditions provided in the Indenture, First Mortgage Bonds of other series may be issued from time to time in the future (1) for the purpose of reimbursing the University for expenditures made by it out of its own funds, on and after the date specified in the Indenture, for the construction or other acquisition of facilities for the housing and feeding of students, fac-

ulty members, and other employees; (2) for the purpose of providing the University with funds for the construction or other acquisition of such facilities; and (3) for the purpose of refunding outstanding First Mortgage Bonds.

Section 103(a) of the Internal Revenue Code of 1954 provides, among other things, that gross income does not include interest on the obligations of a State or any political subdivision thereof.

Section 1.103.1 of the Regulations issued under this section of the 1954 Code provides in part:

> "* * * Obligations issued by or on behalf of the State, Territory, or possession of the United States, or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State, Territory, or possession of the United States, or a political subdivision thereof.* * *"

Based solely upon the facts submitted in your letter dated February 1, 1957, it is our opinion that the interest which will be payable on the proposed bonds to be issued by the University for the purposes so hereinbefore stated comes within the scope of section 103(a) of the Internal Revenue Code of 1954 and that it will, in the hands of the bondholder be excludable from the gross income of the recipient-bondholder for Federal income tax purposes pursuant to the terms of that section.

This ruling is made under the existing provisions of the Internal Revenue Code of 1954. Any material change or modification of applicable statutes will render this ruling ineffective to the extent that it is dependent upon such statutes.

A copy of this communication has been furnished your representative, Mr. C. McKenzie Lewis, Oliver Build-

ing, Pittsburgh, Pennsylvania, in accordance with the authority contained in a power of attorney executed by you under date of February 1, 1957.

Very truly yours,

Director, Tax Rulings Division

Opposition

Office - Supreme Court, U.S.
FILED
MAY 13 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-1673

In the Supreme Court of the United States

OCTOBER TERM, 1981

PHILADELPHIA NATIONAL BANK, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

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In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-1673

PHILADELPHIA NATIONAL BANK, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner[1] seeks review of the decision below in this federal income tax case holding that Temple University is not a "political subdivision" of a State within the meaning of Section 103(a)(1) of the Internal Revenue Code of 1954 (26 U.S.C.), so that interest received by petitioner on loans it had extended to Temple was not tax-exempt under that provision.

The pertinent facts are undisputed and may be summarized as follows: Temple University was organized in 1888 as a privately chartered educational institution under the laws of the Commonwealth of Pennsylvania. In 1965, Temple agreed to be reorganized pursuant to the Temple University-

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[1]References to "petitioner" are to Philadelphia National Bank. Philadelphia National Corporation is a party to this case only because it filed consolidated returns on behalf of itself and Philadelphia National Bank for some of the years at issue.

Commonwealth Act (Pet. App. A3).[2] The stated purpose of the Commonwealth Act was "to extend Commonwealth opportunities for higher education by establishing Temple University as an instrumentality of the Commonwealth to serve as a State-related institution in the Commonwealth system of higher education." Commonwealth Act, Section 2. The Act specifically provides, however, that Temple "shall continue as a corporation for the same purposes as, and with all rights and privileges heretofore granted to, Temple University, unless hereinafter modified or changed."[3] Section 3. Moreover, it leaves control of the University's affairs in the hands of its privately-controlled board of trustees. Sections 4, 5.[4]

The Act does not guarantee Temple any particular level of public funding. It does stipulate, however, that when public funds are appropriated, the Pennsylvania General Assembly may establish tuition and fees schedules, "Provided, That the amounts appropriated * * * are sufficient for the maintenance of such schedules by the university." If the appropriations are deemed insufficient, the University is authorized to alter these tuition schedules to the extent necessary to provide the additional funds believed to be required. Section 6. The Act provides that state capital

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[2]Act No. 355, 1965 Pa. Laws 843 (codified at Pa. Stat. Ann. tit. 24, §§ 2510-1 *et seq.* (Purdon Cum. Supp. 1981)).

[3]The Pennsylvania Supreme Court has noted that this declaration "reveals an express legislative intent to preserve Temple's status as a non-profit corporation chartered for educational purposes." *Mooney* v. *Board of Trustees of Temple University*, 448 Pa. 424, 430, 292 A.2d 395, 399 (1972).

[4]As reconstituted by the Act, Temple's Board of Trustees has 36 voting trustees. Twenty-four of these voting trustees are elected, as they were in the past, by the corporate membership of the University. The remaining 12 voting trustees are appointed by Commonwealth officials. Additionally, three Commonwealth officials serve as trustees ex officio. Section 4.

improvement programs will be available to Temple on terms and conditions comparable to those applicable to state colleges and land grant institutions, and that the Commonwealth "may" acquire land, erect buildings and provide facilities for the use of the University. Section 7.

Insofar as the University's borrowing power is concerned, the Act declares that Temple's board may issue bonds in the University's name for "any proper purpose in the same manner as heretofore." Section 9(a). This provision, however, goes on to deny Temple the power to pledge the credit or the taxing power of Pennsylvania or its political subdivisions and it specifically provides that Temple's obligations shall not be deemed to be "obligations of the Commonwealth of Pennsylvania or of any of its political subdivisions." Section 9(b).

While Temple had previously enjoyed State funding in more modest amounts, the Commonwealth's annual appropriations for 1966 through 1972 provided between 50.6% and 62.7% of the University's unrestricted revenue. Because these appropriations were either delayed or, in Temple's view, inadequate, the University sought loans from petitioner to cover operating expenses and to redeem certain previously-issued bonds. Petitioner set the interest rate on these loans to Temple at the regular commercial rate (Pet. App. A5).

Petitioner originally included the interest accrued on its loans to Temple in its gross income for 1967-1971, but subsequently claimed a refund of taxes for those years on the ground that the interest was tax-exempt under Section 103 of the Code. Upon denial of its refund claim, petitioner brought this refund suit in the United States District Court for the Eastern District of Pennsylvania. The district court agreed with petitioner that Temple qualified as a "political subdivision" of the Commonwealth of Pennsylvania and

that the interest petitioner received on its loans to Temple was therefore tax-exempt under Section 103. In so ruling, the district court concluded that Temple "*exercises* (even if it might not be said to 'possess')" a substantial portion of each of the three principal sovereign powers of a state, *i.e.*, the police power, the power of taxation, and the power of eminent domain (Pet. App. A36). In the district court's view, Temple exercised the police power because it maintained a campus police force with arrest powers, and because it had the authority to promulgate codes of conduct for its students. It further concluded that, even though Temple did not itself possess the powers of taxation and eminent domain, it was sufficient, for purposes of Section 103, that Temple enjoyed the benefit of the Commonwealth's exercise of those powers (*id.* at A36-A37).

The court of appeals reversed. It first noted that, in *Mooney* v. *Board of Trustees of Temple University*, 448 Pa. 424, 292 A.2d 395 (1972), the Pennsylvania Supreme Court held that, despite the connections between Temple and the Commonwealth of Pennsylvania under the Commonwealth Act, Temple was still essentially a private corporation, and neither a state agency nor a political subdivision for state law purposes (Pet. App. A9-A10). The court also concluded that Temple did not possess any of the sovereign powers of the State to any significant degree. The court recognized that the police power denotes broad legislative authority to enact measures for the public health and welfare, and that this power is far broader than Temple's power to maintain a campus police force. Indeed, its authority to enact codes of student conduct is no greater than that of any other private corporation.[5] Finally, the

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[5]Petitioner states (Pet. 7 n.1) that the court of appeals erred in concluding "that the campus police are not authorized to enforce laws enacted by the University and charges may not be brought before school authorities." The court of appeals, however, was obviously referring

court concluded that none of the State's powers of taxation or eminent domain had been delegated to Temple itself (Pet. App. A11-A14).

1. The decision below correctly held that Temple University is not a "political subdivision" of Pennsylvania. A "political subdivision" of a State, as that term has been construed for the purposes of Section 103 of the Internal Revenue Code, is a "division" of the State which has been delegated the right to exercise part of the State's sovereign powers. Treasury Regulations on Income Tax (1954 Code), Section 1.103-1(b) (26 C.F.R.); see *Estate of Shamberg* v. *Commissioner*, 3 T.C. 131, aff'd, 144 F. 2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). Here, Temple remains a privately-chartered corporation that is neither controlled by, nor responsible to, the political institutions of the Commonwealth of Pennsylvania, and, for this reason alone, does not constitute a "division" of the State. See *Seagrave Corp.* v. *Commissioner*, 38 T.C. 247 (1962). Furthermore, as the court below concluded (Pet. App. A11-A14), Temple does not possess any significant portion of Pennsylvania's sovereign powers. Hence, even though Pennsylvania provided substantial amounts of public funding for Temple during the years in question, Temple met neither

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(Pet. App. A13) to the campus police in the context of the exercise of their statutory arrest powers. See Pa. Stat. Ann. tit. 71, § 646 (Purdon Cum. Supp. 1981), granting to the campus police of state-related colleges and universities (such as Temple) and state-aided colleges and universities (such as the University of Pennsylvania) the power to make arrests and otherwise enforce Commonwealth laws. While Temple's campus police may also enforce the University's codes of student conduct (by bringing charges against students before University disciplinary committees (see Pet. App. A31, A36)), when the campus police are performing this function the statute does not endow them with any special law enforcement powers. Accordingly, the fact that the campus police have this additional student code enforcement function does not in any way distinguish Temple from any other private educational institution.

of the Regulation's prerequisites for "political subdivision" status for purposes of Section 103.[6]

2. Finally, the court below correctly held (Pet. App. A14-A16) that Temple was not a "constituted authority" empowered to issue obligations on behalf of the State under Section 1.103-1(b) of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.). In order to qualify as a "constituted authority" under that Regulation, an entity must, *inter alia*, have the State's approval for the issuance of the specific obligations in question. Rev. Rul. 63-20, 1963-1 Cum. Bull. 24.[7] Here, Temple was free to borrow the funds

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[6] *Commissioner* v. *Shamberg's Estate, supra,* 144 F. 2d at 998, upon which petitioner relies (Pet. 13), does not conflict with the decision below. It involved a traditional governmental authority which, unlike Temple University, was wholly-owned and state-controlled. Moreover, that authority itself possessed the power of eminent domaint as well as substantial police powers. The court below correctly concluded that *Shamberg* is distinguishable (Pet. App. A8-A9, A12-A15). Petitioner's reliance (Pet. 14-15) on three Internal Revenue Service rulings is likewise unfounded. Rev. Rul. 73-563, 1973-2 Cum. Bull. 24, deals with the status of a transit authority which was created by a state and governed by a board, all of whose members were appointed by public officials. Thus, it is clearly distinguishable from the privately-controlled entity involved here. The other two rulings—private letter rulings regarding the status of Pennsylvania State University—are not proper authority for several reasons. First, as private determinations issued to another taxpayer, neither ruling can be relied on by petitioner here. See, *e.g., Bookwalter* v. *Brecklein,* 357 F. 2d 78 (8th Cir. 1966). Second, these rulings are now of questionable authority even as to Pennsylvania State University itself since the Commissioner, in a more recent published ruling (Rev. Rul. 77-165, 1977-1 Cum. Bull. 21), has ruled that a state university that does not itself possess substantial sovereign powers of the state is not a "political subdivision" for purposes of Section 103. Finally, since Pennsylvania State University, unlike Temple, is a state-created public corporation (see preamble to the Act of Apr. 1, 1863 (Act No. 227), 1863 Pa. Laws 213), those private rulings would be distinguishable from the instant case in any event.

[7] Cf. Proposed Treasury Regulations on Income Tax, Section 1.103-1(c), 41 Fed. Reg. 4829 (1976), which would further provide that the state or other governmental unit must have control of the entity's governing board for that entity to be considered such a "constituted authority."

in question in its own name as a private corporation, and to use the funds for any purpose as it saw fit. It neither needed nor sought prior state authorization for its borrowing (see Pet. App. A15-A16). Nor was the State obligated, in any way, to appropriate additional funds to cover either the principal or the interest on those loans. It is therefore clear that, in obtaining additional capital by borrowing from petitioner, Temple was acting on its own behalf and not as a "constituted authority" for the issuance of obligations on behalf of the State within the contemplation of the Regulations.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

MAY 1982

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